

Sales of canned software are taxable regardless of the means of delivery. See 86 Ill. Adm. Code 130.1935. (This is a GIL).

December 10, 2002

Dear Xxxxx:

This letter is in response to your letter dated August 8, 2002. We apologize for the delay in responding to your inquiry. The nature of your letter and the information you have provided require that we respond with a General Information Letter, which is designed to provide general information, is not a statement of Department policy and is not binding on the Department. See 2 Ill. Adm. Code 1200.120 subsections (b) and (c), which can be found on the Department's Internet website at <http://www.revenue.state.il.us/Laws/regs/part1200/>.

In your letter, you have stated and made inquiry as follows:

We are requesting a general information letter on the issues listed below based on the following fact pattern. We appreciate your immediate assistance in this matter.

Facts

Company A (or 'Company') is a C Corporation incorporated in STATE, and headquartered in STATE2. The following is a description of Company A's service activities in Illinois.

Company A is a service provider that offers Internet management solutions. Company A's primary function is to give its clients the ability to rapidly implement and configure Internet access policies in support of the clients' efforts to improve employee productivity, conserve network bandwidth and mitigate potential legal liability related to Internet access and use. Company A enables its clients to achieve these objectives through the use of its employee Internet filtering services.

Company A's Internet filtering service utilizes two components: application software and a master database. The application software is of no value in itself but is necessary to avail of the Company's on-line services. The application software filters employee access to the Internet based on Internet policies set by the employers, i.e., Company A's clients. The application software (which is loaded on the client's server via the Internet) directs all employees' Internet website (URL) requests to Company A's master database. The master database contains all known Internet websites, which are categorized by Company A in their STATE2 facility. The database is downloaded on a nightly basis to the client's server from one of three Company A servers (two in STATE2 and one outside the US). (Company A does not, as part of its service, charge clients for

the line or other transmission charges which are used to obtain access to the Internet). The employee's URL request is processed in the database to determine whether the website requested is approved for the particular user. Access to the website is either granted or denied based on the Internet policies set forth in the application software. Company A's clients access the application software free via the Internet.

Company A's revenue is generated by selling subscription contracts to clients for the Internet filtering services. Subscription contracts range from one to three years with full up-front cash payments made once a client accepts the contract. Upon acceptance of the contract terms, a key (similar to a password) is sent to the client via the Internet, which allows the client access to the Company's software and database.

Issues

- 1) Is Company A's sale of Internet filtering services subject to the retailers' occupation tax ('ROT'), the use tax ('UT'), the service occupation tax ('SOT'), or the service use tax ('SUT') in the State of Illinois?
- 2) Is Company A's sale of Internet filtering services subject to the telecommunications excise tax in the State of Illinois?
- 3) Is Company A's sale of Internet filtering services subject to the Chicago transaction tax in the State of Illinois?

Conclusion

In an effort to expedite this request, below is a summary of our conclusion and research on issues one and two above. We did not analyze issue three.

Company A's Internet filtering services are not subject to Illinois' ROT or UT because the taxes are generally imposed on the retail sale of tangible personal property rather than services. Further, the only tangible personal property transferred pursuant to Company A's subscription sales is software which (1) is transferred without consideration, (2) has no value to the purchaser except as a result of electronic services rendered by the vendor, and (3) is an actual and necessary part of the service rendered.

Company A's Internet filtering services are not subject to Illinois' SOT or SUT since the software transferred pursuant to the service is not provided on a disk, tape, or other tangible medium.

Company A's sale of Internet filtering services is not subject to the telecommunications excise tax because such services are excluded from the definition of 'gross charges' *and* the Company does not charge clients for the line or other transmission fees used to obtain access to the Internet.

Discussion of Related Law and Other Authority

The Illinois sales and use taxes are contained in four separate acts: ROT, UT, SOT, and SUT.¹

The ROT is imposed upon 'persons engaged in the business of selling at retail tangible personal property, including computer software, ...'² The UT compliments the ROT in that it is imposed upon 'the privilege of using in this State tangible personal property purchased at retail from a retailer, including computer software...'³ The SOT is 'imposed on any serviceman transferring tangible personal property as an incident to a sale of a service taxable under the SOT...'⁴ Finally, the SUT is imposed 'upon the privilege of using in this State real or tangible personal property acquired as an incident to the purchase of a service from a serviceman, including computer software...'⁵

The common thread among all of the taxes listed above is that they are imposed upon tangible personal property (including software) sold, used, or transferred.

First it is necessary to determine which tax, if any, Company A's services are taxed under. Illinois case law provides guidance on whether Company A is subject to the ROT/UT or the SUT/SOT. The Illinois Supreme Court set a standard for determining which tax applies in the 1971 case *Spagat et al. v. Mahin et al.*⁶ The court determined that the sale of wall-to-wall carpeting is a sale at retail of tangible personal property rather than a service because the installation service rendered is incidental to the sale of the carpet.⁷ In its determination, the court relied on Illinois precedent stating:

If the article sold has no value to the purchaser except as a result of services rendered by the vendor and the transfer of the article to the purchaser is an actual and necessary part of the service rendered, then the vendor is engaged --business of rendering service and not --business of selling at retail. If the article sold is the substance of the transaction and the service rendered is merely incidental to and an inseparable part of the transfer to the purchaser of the article sold, then the vendor is engaged in the business of selling at retail.⁸

In the case of Company A, it is clear that the software by itself has no value to Company A's clients, the purchaser, except as a result of electronic service rendered by Company A, the vendor. Additionally, the transfer of the software to the client/purchaser is an actual and necessary part of the service rendered. As such, Company A's Internet filtering services are not subject to Illinois' ROT or UT because the taxes are imposed on the retail sale of tangible personal property and not on the sale of services.

It is also important to note that the software transferred is not even sold pursuant to the ROT or UT. As noted above, the ROT is imposed on, 'persons engaged in the business of selling at retail tangible personal property, including computer software, ...'⁹ The term 'sale at retail' is 'any transfer of the ownership of or title to tangible personal property to a purchaser, for the purpose of use...for a valuable consideration...'¹⁰ As such, the transaction is not subject to the ROT because Company A's software is transferred to its clients without consideration. The UT is imposed for 'the privilege of using in this State tangible personal property purchased at retail from a retailer, including computer software...'¹¹ The term 'purchase at retail' means 'the acquisition of the ownership of or title to tangible personal property through a sale at retail.'¹² As with the ROT, the transaction is not subject to the UT because Company A's software is transferred to its clients without consideration.

Based on the foregoing, Company A's Internet filtering services are not subject to Illinois' ROT or UT because the taxes are imposed on the retail sale of tangible personal

property rather than services. Further, the only tangible personal property transferred pursuant to Company A's subscription sales is software, which (1) is transferred without consideration, (2) has no value to the purchaser except as a result of electronic services rendered by the vendor, and (3) is an actual and necessary part of the service rendered.

Now that it is established that Company A is not subject to the ROT or UT, it is necessary to examine the applicability of the SOT and SUT. As noted above, these taxes are imposed upon the privilege of using or transferring tangible personal property acquired as an incident to the purchase of a service from a serviceman.¹³ Software is considered tangible personal property for the purposes of the SOT and SUT.¹⁴ As such, providing free computer software generally results in a use tax liability to the company giving away the software.

As stated in the fact pattern, Company A's internally developed software is given away to its clients free of charge and is delivered to its clients via Internet download. Illinois' gift regulations give guidance as to the tax treatment of products developed internally and products provided to clients free of charge. In general, a donor incurs a Use Tax liability on the 'cost price' of the item transferred to a donee free of charge.¹⁵ If the donor is the manufacturer of the item, the tax liability is based on the manufacturer's 'cost price' of materials purchased to fabricate the item.¹⁶ The term 'cost price' means:

the consideration paid by the serviceman for a purchase valued in money, whether paid in money or otherwise, including cash, credits and services, and shall be determined without any deduction on account of the supplier's cost of the property sold or on account of any other expense incurred by the supplier...¹⁷

In the situation at hand, a 'cost price' is not associated with Company A's software since it is internally developed and ultimately transferred to clients over the Internet (i.e., it is not transferred on a tangible medium). The Department addressed the issue of 'cost price' with respect to the transfer of free custom software in a General Information Letter dated December 30, 1994. In that letter the Illinois Office of General Council stated the following:

When the company prepares custom computer programs, the company incurs Use Tax on the cost price of the disk or tape or other tangible personal property that is transferred. If the company purchased 'canned software' to give to its clients, it would incur Use Tax based on its cost price of the canned¹⁸ software...

Based on this, it is reasonable to conclude that Illinois would treat a transfer of canned software in the same manner as custom software. This means that Company A should not incur the SOT or SUT with respect to its transfer of software to its clients, for no consideration, since the software is internally developed and is transferred to clients on a non-tangible medium, i.e., via the Internet.

Illinois also imposes a telecommunications excise tax upon the act or privilege of originating or receiving intrastate or interstate telecommunications in the State at the rate of seven percent of the gross charges for such telecommunications purchased at retail from retailers.¹⁹ The term 'gross charges' excludes:

...Charges for automated data storage, retrieval and processing services or for the use of computer time or other equipment are not included in gross charges. Automated information retrieval or data processing charges are not included in gross charges. For example, a client who accesses an on-line computer data base would not be subject to tax on the charge for the data processing or inquiry, but would be subject to tax on the charge for the transmission of the data.²⁰

Company A's service is not subject to the Illinois Telecommunications Excise Tax because such services are excluded from the definition of 'gross charges' *and* the Company does not charge clients for the line or other transmission fees used to obtain access to the Internet.

Summary

The ROT and UT are imposed on the retail sale of tangible personal property rather than services. The only tangible personal property transferred pursuant to Company A's subscription service is software, which (1) is transferred without consideration, (2) has no value to the purchaser except as a result of electronic services rendered by the vendor, and (3) is an actual and necessary part of the service rendered. As such, Company A's Internet filtering services are not subject to Illinois' ROT or UT.

Company A's Internet filtering services are also exempt from the Illinois' SOT or SUT since the software is (1) transferred to clients free of charge and (2) not transferred to clients on a disk, tape, or other tangible personal property.

Finally, Company A's sale of Internet filtering services is not subject to the telecommunications excise tax because (1) such services are excluded from the definition of 'gross charges' *and* (2) the Company does not charge clients for the line or other transmission fees used to obtain access to the Internet.

Please call me should you have any questions.

Thank you for your time and attention.

DEPARTMENT'S RESPONSE:

Issue 1:

The Illinois Retailers' Occupation Tax Act imposes a tax upon persons engaged in this State in the business of selling tangible personal property to purchasers for use or consumption. See 86 Ill. Adm. Code 130.101. In Illinois, Use Tax is imposed on the privilege of using, in this State, any kind of tangible personal property that is purchased anywhere at retail from a retailer. See 86 Ill. Adm. Code 150.101.

Based upon the information in your letter, the software described as "application" software would likely be considered canned computer software. Generally, sales of "canned" computer software are taxable retail sales in Illinois. See 86 Ill. Adm. Code 130.1935. Sales of canned software are taxable regardless of the means of delivery. For instance, the transfer or sale of canned computer software downloaded electronically would be taxable. However, we believe that

the transfer of application software described in your letter is merely incident to the sale of your clients Internet filtering services. Therefore, no Retailers' Occupation Tax liability would be incurred by your client on the transfer of that software and the customer would not incur a corresponding Use Tax liability.

We believe that the transfer of the application software being incident to the sale of your clients Internet filtering services may result in either Service Occupation Tax or Use Tax liability depending upon its activities and whether the sale of those services occur in this State. For your general information see 86 Ill. Adm. Code 140.101 through 140.109 regarding sales of service and Service Occupation Tax. The serviceman's liability may be calculated in one of four ways: (1) separately stated selling price of tangible personal property transferred incident to service; (2) 50% of the servicemen's entire bill; (3) Service Occupation Tax on the servicemen's cost price if the servicemen are registered de minimis servicemen; or (4) Use Tax on the servicemen's cost price if the servicemen are de minimis and are not otherwise required to be registered under Section 2a of the Retailers' Occupation Tax Act. In regards to the first three methods, service customers incur a corresponding Service Use Tax liability. The last method imposes a Use Tax liability on the serviceman, not his service customer.

You have indicated that the application software is loaded on Company A's clients' server via the Internet. Therefore, Company A's clients may have a Service Use Tax liability regarding the transfer and use of the application software on the clients' server if that server is located in this State. See 86 Ill. Adm. Code 160.101. Without more knowledge regarding whether Company A has nexus with Illinois and its appropriate tax base (see the first three methods above), we cannot determine if Company A would be required to collect and remit Service Use Tax from its Illinois customers.

Issue 2:

The Telecommunications Excise Tax is imposed upon the act or privilege of originating or receiving intrastate or interstate telecommunications in Illinois at the rate of 7% of the gross charges for such telecommunications purchased at retail from retailers. See 86 Ill. Adm. Code 495.

Pursuant to Section 495.100(a), "gross charge" means the amount paid for the act or privilege of originating or receiving telecommunications in this State and for all services and equipment provided in connection therewith by a retailer, valued in money, whether paid in money or otherwise, including cash credits, services and property of every kind or nature, and shall be determined without any deduction on account of the cost of such telecommunications, the cost of material used, labor or service cost or any other expense whatsoever. A retailer may provide services to customers that are not provided in connection with originating or receiving telecommunications. If such services are not necessary for or directly related to the retailer's provision of telecommunications to customers and the charges for such services are disaggregated and separately identified from other charges, the charges need not be included in "gross charges."

As noted in Section 495.100(c), charges for automated information retrieval or data processing are not taxable. The regulation contemplates that charges for access to an on-line computer database or the downloading of data from such a database fall within this category. Charges for the inquiry or the data are generally not taxable, but charges, if any, for transmission of the data are generally subject to the Telecommunications Excise Tax. If telecommunications retailers provide both transmission and data processing services, the charges are subject to tax unless the charges for each are disaggregated and separately identified in the books and records of the retailers. Based upon the limited information contained in your letter, your client would not generally incur

Telecommunications Excise Tax liability as long as it does not charge its customers for the line or any transmission charges.

Issue 3:

We cannot provide you with any information regarding the "Chicago transaction tax" referenced in your letter. The Illinois Department of Revenue does not administer such a tax. We recommend that you contact the revenue department of the City of Chicago for that information.

I hope this information is helpful. The Department of Revenue maintains a website, which can be accessed at www.revenue.state.il.us. If you have further questions related to the Illinois sales tax laws, please contact the Department's Taxpayer Information Division at (217) 782-3336.

If you are not under audit and you wish to obtain a binding Private Letter Ruling regarding your factual situation, please submit all of the information set out in items 1 through 8 of Section 1200.110(b) described above.

Very truly yours,

Terry D. Charlton
Associate Counsel

TDC:msk
Enc.

¹ 35 ILCS 120/14; 35 ILCS 105/1; 35 ILCS 115/1; 35 ILCS 110/1

² 35 ILCS 120/2

³ 35 ILCS 105/3

⁴ 35 ILCS 115/3-40

⁵ 35 ILCS 105/3

⁶ *Illinois Supreme Court, Docket No. 44176, November 30, 1971, 277 N.E.2d 834, 50 Ill2d 183 Spagat et al. v. Mahin et al*

⁷ *Illinois Supreme Court, Docket No. 44176, November 30, 1971, 277 N. E. 2d 834, 50 Ill2d 183 Spagat et al. v. Mahin et al*

⁸ *Illinois Supreme Court, Docket No. 44176, November 30, 1971, 277 N.E.2d 834, 50 Ill2d 183 Spagat et al. v. Mahin et al citing Velten & Pulver, Inc. v. Department of Revenue, 29 Ill. 2d 524, 529; Dow Chemical Co. v. Department of Revenue, 26 Ill. 2d 283, 285; Kellogg Switchboard & Supply Corp. v. Department of Revenue, 14 Ill. 2d 434, 437.*

⁹ 35 ILCS 120/2

¹⁰ 35 ILCS 105/2; 35 ILCS 120/1

¹¹ 35 ILCS 105/3

¹² 35 ILCS 105/2; 35 ILCS 120/1

¹³ 35 ILCS 115/3-40; 35 ILCS 105/3

¹⁴ 35 ILCS 115/3-40; 35 ILCS 105/3

¹⁵ 86 m. Adm. Code 150.305

¹⁶ 86 m. Adm. Code 150.305

¹⁷ 35 ILCS 110/2; 35 ILCS 115/2

¹⁸ ST 94-0621-GIL, December 30, 1994.

¹⁹ 86 Ill. Adm. Code 495.100

²⁰ Ill. Admin Code 495.100(c)